Sequestration and Its Potential Impact on Fairfax County

October 2012

"Fiscal Cliff"

The term "fiscal cliff" has become shorthand for a group of budget policy changes that will be coming together around January 1, 2013. Without congressional action, the Bush-era tax cuts, the temporary payroll tax cut and extended unemployment benefits are all scheduled to expire, just as higher Medicare taxes and deep cuts to discretionary spending under the Budget Control Act of 2011 (BCA) take effect. If all these budget policy changes were implemented, they could reduce the budget deficit substantially. However, the Congressional Budget Office (CBO) estimates that the combination of higher taxes and deep spending cuts could create a 4 percent reduction in Gross Domestic Product (GDP), a number big enough to throw the country into another recession. The adverse impact of these changes on the economy in the short-term has led to calls to extend some or all of the tax cuts, and to replace the across-the-board spending reductions with more targeted cutbacks.

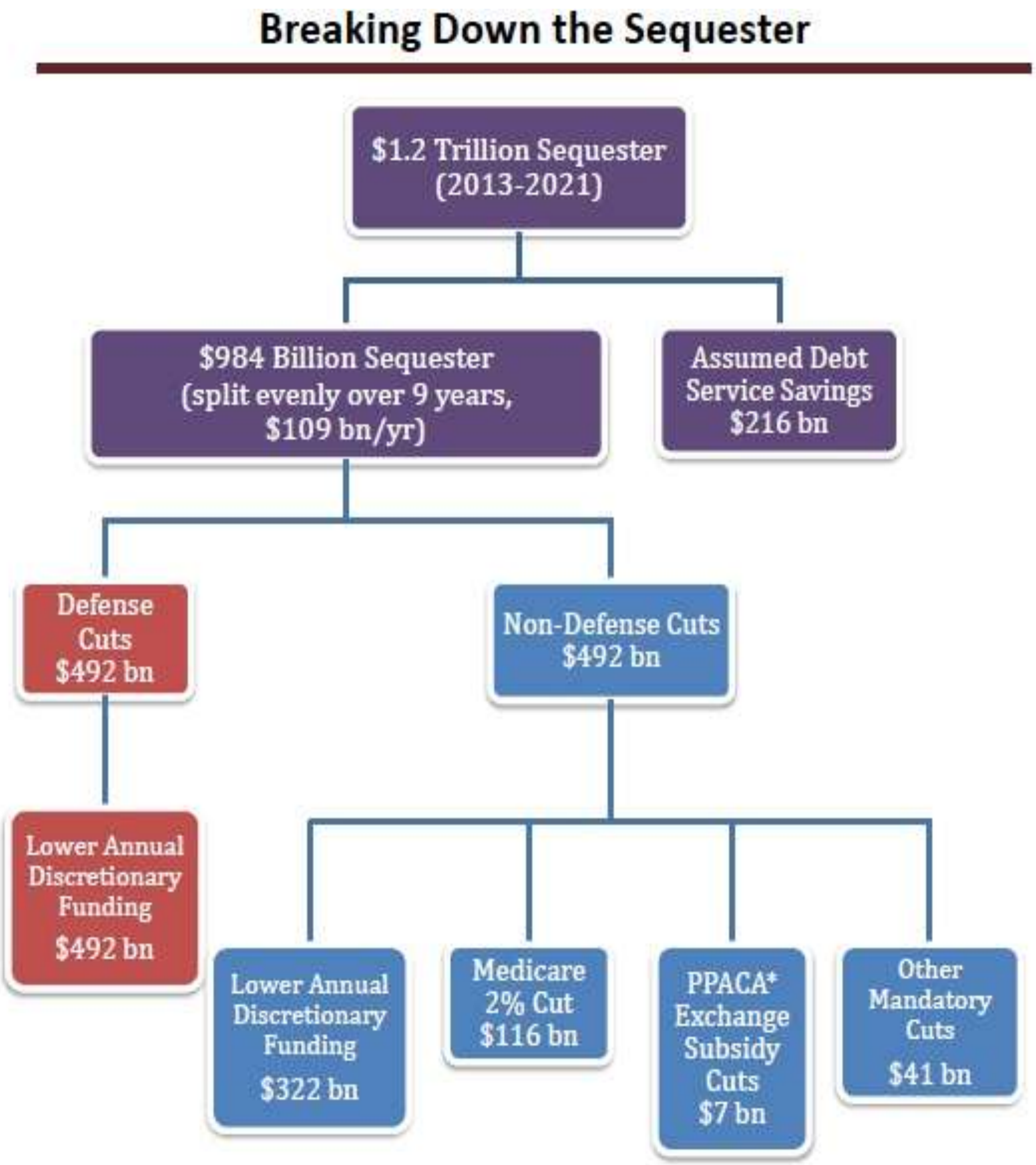
Sequester Mechanics

The Budget Control Act of 2011 established mandatory spending reductions by putting formal caps on non-entitlement discretionary spending that will reduce funding by $1 trillion from 2012 to 2021, relative to CBO's baseline from 2010. The law also established a Joint Select Committee on Deficit Reduction (the "Supercommittee") to produce bipartisan legislation by November 2011 to reduce projected deficits by at least an additional $1.2 trillion through 2021. The group failed to reach a deal, triggering across-the-board budget cuts, also known as sequestration, scheduled to begin in January 2013.

Sequestration is an automatic reduction to federal government spending for a given fiscal year. Beginning in FY 2013, the sequester is scheduled to reduce federal expenditures for nine consecutive fiscal years such that the cuts, including associated debt service savings, total $1.2 trillion. Of that amount, $216 billion are estimated to come from debt service savings. The remaining $984 billion will come from cuts divided evenly in each of the nine relevant years, which equates to $109 billion sequestered each year. The annual cuts are, in turn, split evenly between defense and non-defense spending – an approximate cut of $55 billion to each.

- If the sequester is implemented, defense and non-defense discretionary spending will be cut to the lowest levels as a percentage of the economy in the modern era.
- Most mandatory spending is exempt from sequestration. This includes Social Security, retirement programs, veteran's benefits, refundable tax credits, Medicaid, the Children's Health Insurance Program (CHIP), unemployment insurance, food stamps (SNAP), Temporary Assistance for Needy Families (TANF), and a host of other programs benefitting low-income individuals.

- Medicare is subject to sequestration in the form of provider cuts, but those cuts cannot exceed 2 percent.



**Patient Protection and Affordable Care Act*
Source: Bipartisan Policy Center

- The Office of Management and Budget (OMB) estimates that the $55 billion in defense cuts mandated by the sequester for FY 2013 would force a 9.4 percent reduction to discretionary defense programs – except those exempted in the sequestration law – and a 10 percent cut to some defense-related programs that are not subject to annual congressional appropriations. The cuts to non-defense discretionary and mandatory spending would require across-the-board reductions in domestic programs of approximately 8 percent.

General Economic Conditions

The US economy has stalled in a lackluster recovery from the largest recession since the Great Depression. Employment growth has slowed over the past several months, sending a stark signal that the country's economic recovery continues to fall short of what is needed. Long-term unemployment figures remain near their record highs, economic growth remains tepid at best, and businesses continue to hold back on their investments.

There is a broad consensus that the indiscriminate nature and immediacy of the sequester's cuts to defense and non-defense spending in FY 2013 would cause harmful repercussions throughout the economy.

- The Bipartisan Policy Center estimates that the full defense and non-defense sequester would reduce GDP by roughly half a percentage point in calendar year (CY) 2013. For reference, the CBO projects real GDP to grow at only 2.1 percent next year. The Center's analysis also implies that the sequester cuts could cost the economy more than one million jobs over two years at a time when the unemployment rate continues to hover around 8 percent. A large majority of the layoffs would come from the private sector. The effects of the sequester are already starting to be felt in certain sectors of the economy. Due to the highly uncertain environment, federal contractors are starting to plan ahead and are making personnel, investment, and other significant adjustments.

- Dr. Stephen Fuller from George Mason University estimates that as a consequence of sequestration, GDP growth in 2013 would be reduced by two-thirds and unemployment would increase by as much as 1.5 percentage points, costing the U.S. economy 2.14 million jobs and decreasing personal earnings of the workforce. According to Dr. Fuller, other negative impacts would be driven by behavioral factors: loss of consumer confidence would suppress spending and increase personal saving, thus taking further spending out of the economy. Business investment and private sector hiring may be dampened due to increased uncertainty. These and other collateral impacts would enlarge the negative consequences of the federal spending reductions and contribute to further deepening of the economic contraction in 2013.

Many companies likely will begin announcing their plans to lay off large numbers of workers. In fact, Booz Allen Hamilton has already declared that it is taking "a more conservative approach" to hiring in order to preempt some of the potential damage. The detrimental impacts on the economy will become more pronounced as months go by with no definitive action by policymakers.

Sequester Impact on Virginia

It is unclear at this time what the potential reduction in federal spending growth would mean for specific programs of interest to the state and Fairfax County in particular. There have been several analyses that have reported on the impacts of the sequestration on specific industries or specific states, and they have all concluded that the BCA would cause a broad based loss of jobs, personal earnings, and reduced GDP. Cuts in federal procurement, federal workforce, and other items of direct spending will affect some states' economies more profoundly than others.

- Virginia is particularly vulnerable to the federal spending cuts due to its dependence on defense procurement and significant concentration of federal workers and retirees. Total direct federal spending per capita in Virginia – including procurement, retirement, and other spending – is 60 percent above the national average and accounts for about 32 percent of Virginia's Gross State Product (GSP). Virginia ranks first in federal procurement, which makes up more than 13 percent of its GSP. Federal salaries and wages constitute approximately 5 percent of Virginia's GSP. In 2011, in fact, Moody's assigned Virginia a negative outlook on grounds that "what we are seeing now is a structural shift, where now a great source of stability (Northern Virginia's economy) is becoming a potential vulnerability, because of federal downsizing."

- Dr. Fuller estimates that, of the 2.14 million jobs likely to be lost due to the sequester, Virginia accounts for 9.7 percent, or about 208,000 job losses. The sectors with the highest job losses would be the professional and business services, manufacturing, and the federal government. Based on Dr. Fuller's analysis, Virginia's GSP would decrease by $21 billion, or 5 percent, and personal earnings would decline by $11 billion.

- The Report of the State Budget Crisis Task Force asserts that even if Congress manages to avoid the sequester, over the long run federal grants to state and local governments will almost certainly be cut as a budget reduction measure. If cut by 10 percent, the loss to state and local government budgets would be more than $60 billion annually. The report estimates that Virginia's share would be $1 billion annually. For reference, in FY 2011, the state received $11.35 billion in federal grants and contracts. Potential grant cuts include reductions in Medicaid programs, Highway Trust Fund, TANF, Title 1 education programs, and Child nutrition programs.

Perspectives on Fairfax County

Fairfax County has for years benefited from its proximity to the federal government. A downsizing in the federal sector could have ripple economic and fiscal effects on the County. However, many of these effects would not be observed immediately. While the threat of federal spending reductions and the looming "fiscal cliff" cannot be downplayed, the direct impact of the sequestration on the County is difficult to project. Below are some general observations about potential risks for the County related to federal sequestration.

• County's budget perspectives

While only 1 percent of the County's General Fund revenues come from the federal government, other funds, and many programs of the Fairfax County Public Schools (FCPS), rely to a much greater extent on federal revenues, and thus are more vulnerable to federal spending cuts. There are significant federal grant dollars in the County's budget and our residents receive important services that are funded by additional federal pass through dollars, particularly in the human services area. Thus, the most significant concern from a budget perspective is reductions of federal funding for schools, human services, grants, and housing.

In FY 2011, the County received $289.6 million from the federal government. Should these revenues decline as a result of the sequester, the County would likely have to make adjustments to address short- and long-term funding issues. It should be noted that the Board of Supervisors set aside a "Reserve for Pending Federal Sequestration Cuts" of $7 million at the *FY 2012 Carryover Budget Review* to ensure the County's ability to address changes during FY 2013 that could dramatically impact services.

Top Federal dollars in the County's Budget*

SCHOOLS

- FCPS Operating Fund – $76.7 million
- FCPS Grants – $35.6 million
- FCPS Food and Nutrition – $26.6 million

COUNTY

- Federal Grants – $58.4 million
- General Fund – $38.4 million
- Community Dev. Block Grant – $8.4 million
- Community Services Board – $7.8 million
- Housing Assistance Program – $6.7 million
- Aging grants and programs - $2.3 million

** FY 2011 Actual*

In addition to the risk of fewer federal dollars in the County's budget, any layoffs in the federal government and federally-dependent industries such as federal contractors could increase the demand for social services by County residents and put further pressure on the County's budget. Reductions in federal social services expenditures, coupled with increased demand for services, would require the County to reevaluate programs and make necessary funding adjustments.

- ## County's economic and revenue perspectives

Property Values and Real Estate Taxes

Federal spending accounts for roughly 40 percent of the D.C. metro area's economy, according to Dr. Fuller's analysis. As a result of the federal spending cuts, he says, "[t]here will be fewer high-income households that can afford big houses. So we could see a rollback on housing values."

Real property taxes comprise over $2.0 billion, or more than 60 percent, of the County's General Fund receipts and as such, fund the lion's share of County's disbursements. Real estate sales transactions on which assessments will be based for FY 2014 budget are already set through the first nine months of calendar year 2012, so assessments as of January 2013 would likely not be negatively impacted. In addition, if office vacancy rates start increasing in calendar year 2013 due to businesses consolidating office space, there would be significant downward pressure on commercial real estate assessment values.

As real estate values are a lagging indicator of economic trends, declines in assessments may not occur until calendar year 2013 or later, which would potentially impact FY 2015 real estate assessments. For example, during the slowdown and subsequent correction in the County's housing market in 2006 and 2007, as evidenced by fewer home sales, increased inventory of homes for sale, and houses taking longer to sell, real estate assessments remained relatively flat in FY 2008 and FY 2009, and did not decline until FY 2010.

Related to Real Estate Taxes are Recordation and Deed of Conveyance Taxes, which are paid in association with the sale or transfer of real property located in the County. These taxes are relatively more sensitive to variable market conditions and could begin to decline during FY 2013. Currently, Recordation Tax revenues have not been affected as mortgage interest rates are at historically low levels and as a result the County has experienced increased number of home sales and refinancing transactions.

Consumer Demand, Sales Taxes, and Personal Property Taxes

The loss of confidence by both consumers and businesses would likely suppress spending and increase saving. This in turn could impact County's consumption related tax revenues, such as Sales Tax. Sales tax revenues could also be negatively impacted due to income loss as a result of reductions in the federal workforce and layoffs of federal contractors. Downward pressure on hotel occupancy and room rates due to lower federal and federal contractors' travel-related spending could negatively impact the Transient Occupancy Tax, another consumption related tax. These effects could be felt as early as the second half of FY 2013.

In addition, the economic insecurity would likely suppress business and consumer demand for new vehicles. This may affect the County's Personal Property Tax revenues, but probably not until FY 2014. Business personal property taxes could also be negatively impacted. These taxes are based on the assessed value of all business property located in the County as of January 1 of the current calendar year, so FY 2013 revenues would not be affected. The sequester is likely to discourage businesses that are dependent on the federal government, such as federal contractors, from making new machinery and equipment purchases; therefore, the County should be prepared for lower business personal property tax collections in FY 2014 and in subsequent years if the sequester takes place.

Presence of the Federal Government in Fairfax County

- Federal procurement contract awards in FY 2010* – $24.3 billion
    - Defense – $16.2 billion
    - Non-defense – $8.1 billion
- Personal earnings from federal employment in FY 2010* – $6.5 billion, or 9.9% of all personal earnings in the County
    - Civilian – $5.6 billion
    - Military – $0.9 billion
- Federal government civilian employment – 23,361, or 4.0% of all jobs in the County**

** latest available data*

*** Virginia Employment Commission QCEW 1Q 2012*

Business License Taxes

County businesses that rely on federal procurement are sources of business license (BPOL) taxes. Since BPOL taxes are based on gross receipts from the previous calendar year, and current federal contracts could be expected to continue for some time, these effects would likely be delayed until FY 2014. The Department of

Management and Budget (DMB) estimates that if Gross County Product (GCP) declined 5 percent in calendar year 2013 as a result of the sequester, County's BPOL revenue would decline over 6 percent in FY 2014.

County's Revenues and Risks

	FY 2013 Revenues ($millions)	Percentage of Total County Disbursements	Risks
Property Related Taxes			• Loss of household income decreases ability to afford a mortgage • Home sales decrease • Increased foreclosures • Downward pressure on housing market and real estate assessments • Increase in office vacancy rates negatively impacts commercial real estate values • Economic insecurity suppresses business and consumer demand for new vehicles • Effects on property related taxes would likely be delayed until FY 2015 or later, except for Recordation/Deed of Conveyance taxes
Real Estate Tax	$2,116.5	59.8%	
Personal Property Tax (on vehicles and PSC)	424.6	12.0%	
Recordation and Deed of Conveyance Taxes	25.6	0.7%	
Total Property Related Taxes	**$2,566.7**	**72.5%**	
Business Related Taxes			• Cuts to federal procurement lowers gross receipts for federal contractors • Federal spending cuts lead to fewer machinery and equipment purchases by federal contractor businesses • Reductions in federal workforce and layoffs at federal contractor businesses suppress
Business License Taxes (BPOL)	$157.7	4.5%	
Business Personal Property Tax	118.8	3.4%	
Total Business Related Taxes	**$276.5**	**7.9%**	

	FY 2013 Revenues ($millions)	Percentage of Total County Disbursements	Risks
			consumer demand due to income loss • Effects on business related taxes would likely be delayed until FY 2014
Consumption Related Taxes			• Reductions in federal workforce and layoffs at federal contractor businesses suppress consumer demand due to income loss • Lower federal and federal contractors' travel-related spending puts downward pressure on hotel occupancy and room rates • Effects on consumption related taxes could be felt as early as the second half of FY 2013
Sales Tax (County)	$166.9	4.7%	
Sales Tax (Schools Operating)	160.8	4.5%	
Transient Occupancy Tax	19.5	0.5%	
Total Consumption Related Taxes	**$347.2**	**9.7%**	
Revenues from the Federal Government			• Federal budget cuts lead to decreased federal grants and federal pass through funding • Effect of federal budget cuts on the Commonwealth's budget are also considered a risk • Fewer federal dollars going to the state's budget could lead to further reductions in state's support to local governments • Effects could be felt as early as the second half of FY 2013
General Fund	$34.3	1.0%	
Federal Grants (County)	57.7	1.6%	
Federal Aid (Schools Operating)	41.4	1.2%	
Federal Grants (Schools)	32.7	0.9%	
Food and Nutrition (Schools)	27.9	0.8%	
Other	20.4	0.6%	
Total Revenues from the Federal Government	**$214.4**	**6.1%**	

Can the sequester be avoided?

The sequester can be avoided if Congress passes another budget deal that would achieve at least $1.2 trillion in deficit reduction. If legislators try to avoid the sequester without replacing it with real deficit reduction, the U.S. could face another credit downgrade. Both Democrats and Republicans have offered deficit reduction proposals to replace the sequester, but there still isn't much progress on a deal. While there may be some signs that bipartisan negotiating in the Senate could result in more than a dozen GOP senators conceding to increased taxes on the wealthy as part of a compromise, there is, as yet, no corresponding movement in the Republican-controlled House. No one on Capitol Hill thinks any deal will happen before Election Day. After November 6, Congress will have a short time to come up with an alternative to the sequester. There is already talk of passing a short-term stopgap budget plan during the lame-duck session to buy legislators more time to come up with a "grand bargain".

County staff will closely monitor developments as they relate to the federal sequestration and the impending "fiscal cliff". Staff will also track budgetary and economic indicators to anticipate any longer-term effects of federal budget reductions and prepare options to respond to them. During the recession, the County made difficult short- and long-term changes to achieve a balanced budget and ensure long-term fiscal stability. It will continue to follow the Ten Principles of Sound Financial Management in addressing any future fiscal challenges.